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489-353—72——1

In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-523

PLANTATION PATTERNS, INCORPORATED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

JOHN S. JEMISON, JR. AND MARIE S. JEMISON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (¶ 70,182 P-H Memo TC) is not reported. The opinion of the court of appeals (Pet. App 2a-24a) is reported at 462 F. 2d 712.

JURISDICTION

The judgment of the court of appeals was entered on June 15, 1972. (Pet. App. 1a.) A petition for rehearing was denied on July 6, 1972. (Pet. App. 2a.) The petition for a writ of certiorari was filed on September 30, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the courts below were correct in holding that, under the circumstances of this case, the application of the corporate petitioner's earnings to the discharge of an obligation guaranteed by its sole shareholder, one of the individual petitioners, constituted a dividend taxable to the individual petitioners under Sections 301 and 316 of the Internal Revenue Code of 1954, and gave rise to no interest deduction for the corporate petitioner under Section 163(a).

STATUTES INVOLVED

The pertinent provisions of Sections 163, 301, 302, and 316 of the Internal Revenue Code of 1954 are set forth in the Appendix to the Petition. (Pet. App. 25a–26a.)

STATEMENT

The corporate petitioner, Plantation Patterns, Inc. ("New Plantation") was organized by the individual petitioners in 1962 under the laws of Alabama to acquire and operate a wrought iron furniture business then and previously operated by another Alabama corporation of the same name ("Old Plantation"). (Pet. App. 5a–6a.) The somewhat intricate arrange-

ments for the transfer and for the payment of the purchase price have given rise to this litigation in which the Commissioner of Internal Revenue asserted, and the courts below held, that the corporate petitioner's payments on the purchase price constituted dividends taxable to its sole shareholders, the individual petitioners. The transaction giving rise to the controversy, as largely stipulated, and as found by the courts below, was as follows:

During several years prior to 1962, Old Plantation was engaged in the manufacture and sale of wrought iron furniture in Birmingham, Alabama, and in the manufacture and sale of metal office chairs at Leeds, Alabama. Its stock was owned by five shareholders, two of whom, Thomas E. Jernigan and William C. Jernigan, owned an aggregate of 243,201 of the 270,000 shares outstanding, and were the principal officers of the corporation. Following the abandonment of plans for a public offering of stock in order to raise needed capital, the Messrs. Jernigan decided that it would be wise to sell the wrought iron furniture business and to develop the metal chair business. During the summer of 1962 the five shareholders of Old Plantation decided as a group to sell their Old Plantation stock. (Pet. App. 3a–4a.)

During the summer of 1962, inquiry was made of the petitioner, John S. Jemison, Jr., whether he would be interested in purchasing or finding a purchaser for the Old Plantation stock. Mr. Jemison was an investment banker of some twenty years' experience. He was the president and sole stockholder of Jemison

Investment Company, Inc., a corporation with assets of eleven million dollars that included such varied enterprises as subsidiaries engaged in public transportation, in manufacturing, and in the operation of department stores in Florida and Alabama. He had arranged for the acquisition of businesses both for clients of the Investment Company and for its own account, both as purchases of assets and as purchases of stock. (Pet. App. 4a–5a.)

In August, 1962, Mr. Jemison wrote to Mr. Thomas Jernigan making a conditional offer to purchase the "assets of the Plantation Patterns Division." The letter set forth a plan for forming a new corporation to effectuate the purchase, a corporation that would have capital of $5,000 in common stock and would borrow $150,000 on notes to be subordinated to a purchase money obligation running to the seller of the wrought iron furniture assets. (Pet. App. 5a.)

The stockholders of Old Plantation made an independent investigation of Mr. Jemison's credit, and then accepted, with modifications, the proposal made by Mr. Jemison. The modified agreement called for New Plantation, the corporation to be organized, to purchase the stock of Old Plantation for a stated price equal to the net worth of Old Plantation plus $644,909.53, or a total of $893,314.17. The agreement contemplated that New Plantation would liquidate Old Plantation upon acquisition of its stock, and would then sell to Messrs. Thomas and William Jernigan the assets of the metal chair division for $183,-

435.84, their book value. The purchase price for the Old Plantation stock was to be paid as follows:

(1) A cash payment of $100,000 at the time of closing;

(2) An amount equal to the book value of the metal chair division ($183,435.84) payable without interest in installments in January, March, and June, 1963;

(3) The balance ($609,878.33) in equal installments of $50,000 beginning October 1, 1963, and annually thereafter, with a final installment of $109,878.33 due on October 1, 1973. Notes representing these installments were to be guaranteed by the Jemison Investment Company, and by Mr. Jemison personally. (Pet. App. 7a.)

An agreement embodying these terms was executed on September 28, 1962, with New Plantation and the stockholders of Old Plantation as signatories. Mr. Jemison had caused New Plantation to be organized on September 25, 1962. Its capital of $5,000 was paid in by check of petitioner Marie S. Jemison, Mr. Jemison's wife, and fifty shares of common stock were issued in her name. Mrs. Jemison, though named a director, was not active in the affairs of New Plantation, and she held the stock only by arrangement of Mr. Jemison, as the Tax Court found. (Pet. App. 6a–7a.)

On September 27, 1962, New Plantation obtained $150,000 by loan from Bradford and Company, Inc., an unrelated investment company, for which it issued 6½ percent debentures maturing serially from 1974 to 1976. These debentures were subordinated to all other indebtedness of New Plantation. Bradford and

Company was controlled by Mr. Thomas Bradford, and the loan was made as an inducement to Mr. Jemison to place Mr. Bradford's son with New Plantation. (Pet. App. 6a–7a.)

Upon execution of the agreement between New Plantation and the stockholders of Old Plantation on September 28, 1962, the latter transferred their stock to New Plantation, which promptly liquidated Old Plantation. By another agreement executed the same day, New Plantation agreed to sell the metal chair assets to Messrs. Thomas and William Jernigan for $183,435.84, their book value to Old Plantation, payable without interest in 1963. These assets were promptly transferred, and as a result the Messrs. Jernigan acquired the metal chair assets through an exchange or offset of notes. (Pet. App. 8a–9a.)

On its part, New Plantation, upon execution of the agreement of September 28, 1962, paid the stockholders of Old Plantation $100,000 cash, delivered the non-interest bearing notes for $183,435.84 (later offset or exchanged for the obligations of the Messrs. Jernigan in payment for the metal chair assets), and delivered its 5½ percent notes maturing serially from October 1, 1963 through October 1, 1973. These last notes were guaranteed absolutely as to principal and interest by Mr. Jemison and by the Jemison Investment Company. The Investment Company received a fee of $15,000 annually for its guarantee, but Mr. Jemison received no fee for his guarantee. As the agreement contemplated, these notes, aggregating $609,878.33 in face amount, were, except for $50,000 payable in October,

1963, and $50,000 payable in October, 1964, subordinated to all other indebtedness of New Plantation except the Bradford loan. The notes aggregating $100,000 payable in 1963 and 1964 were not subordinated so that Mr. Jemison could arrange for the holders to discount them at a bank. Like the subordinated notes, they were covered by the guarantees of Mr. Jemison and the Jemison Investment Company. (Pet. App. 8a.)

During the taxable period from October 1, 1962, through September 30, 1966, New Plantation paid principal and interest due on the 5½ percent notes issued to the former stockholders of Old Plantation. It also paid the interest on the 6½ percent debentures issued to the Bradford Investment Company. On its returns for the taxable years ending September 30, 1963, through September 30, 1966, New Plantation accrued and deducted $117,652.65 interest paid on the 5½ percent notes issued to the former stockholders of Old Plantation, as well as the interest on the Bradford loan. (Pet. App. 10a.)

The Commissioner of Internal Revenue disallowed the interest deductions taken with respect to the 5½ percent notes issued to the former stockholders of Old Plantation, and asserted against New Plantation the deficiencies here in issue with respect to it. (Pet. App. 10a.) The Commissioner also asserted against the individual petitioners, Mr. and Mrs. Jemison, a deficiency for the calendar year 1963, asserting that the payments of principal and interest made by New Plantation in that year on the notes issued to the

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former stockholders of Old Plantation constituted dividends to the individual petitioners paid by New Plantation. (Pet. App. 11a.)

The Tax Court found that the assets of New Plantation were wholly inadequate to support a debt of $609,878.33, and that no source would have advanced $600,000 in money or property to New Plantation without the guarantee of Mr. Jemison, who, by virtue of that guarantee, acquired the beneficial interest in the business and assets transferred to New Plantation. Employing familiar debt-equity criteria with respect to the corporation's notes as well as the fact that the stockholders of Old Plantation relied upon Mr. Jemison's credit, the Tax Court concluded that the obligations in form guaranteed by Mr. Jemison should be recognized as primarily his. It therefore treated the payments of principal and interest made by New Plantation as payments upon the obligation of its shareholder, and therefore as taxable dividends. Consequently, it upheld the deficiencies against the corporate petitioner asserted by the Commissioner, and largely upheld the deficiency asserted against the individual petitioners, modifying the latter only to the extent of holding that insofar as the individual petitioners received dividends by virtue of payments on the interest obligation, they should be allowed an offsetting deduction for interest paid.

The court of appeals, after fully reviewing the Tax Court's analysis and conclusions, affirmed its decisions, concluding that "None of the Tax Court's Findings and Conclusions based upon stipulated facts are shown to be 'clearly erroneous.'" (Pet. App. 24a.)

ARGUMENT

The decision below is correct. There is no conflict of decisions, no question of general importance is involved, and there is no other apparent reason for review by this Court.

This case presents one of a number of procedural variants upon a familiar transactional pattern. The prototype transaction is one in which individuals acquire the beneficial interest in the stock or assets of a going business by having the stock or assets transferred to a controlled corporation, frequently organized for that purpose. The individuals thus gaining beneficial ownership of the enterprise are liable for the purchase price, and subsequently have their obligation discharged by payments from the earnings of the controlled corporation. Though the procedural variations upon this transactional structure are numerous, and often complex, the decisions are consistent in holding that the controlled corporation's discharge of its shareholders' obligation constitutes a dividend taxable to the shareholders, as the Commissioner asserted, and the courts below held, in this case. See, *e.g.*, *Wall* v. *United States*, 164 F. 2d 462 (C.A. 4); *Woodworth* v. *Commissioner*, 218 F. 2d 719 (C.A. 6); *Ferro* v. *Commissioner*, 242 F. 2d 838 (C.A. 3); *Zipp* v. *Commissioner*, 259 F. 2d 119 (C.A. 6); *Schalk Chemical Company* v. *Commissioner*, 304 F. 2d 48 (C.A. 9); *Idol* v. *Commissioner*, 319 F. 2d 647 (C.A. 8); *Maher* v. *Commissioner*, 72-2 U.S.T.C. par. 9728 (C.A. 8); *Deutsch* v. *Commissioner*, 38 T.C. 118.

The variation employed in this case was that the acquiring individual's liability for the purchase price

was in the form of Mr. Jemison's guarantee of the largely subordinated obligations issued by the corporation, New Plantation. Cf. *Deutsch* v. *Commissioner, supra.* Under the circumstances of this case, the courts below properly held that that variation was without significance. On a purely factual basis, they noted that the sellers had made an independent investigation of Mr. Jemison's credit. That that was the element upon which the sellers relied was indicated by the fact that the notes executed by New Plantation were not secured other than by the guarantees[1] given and by the fact that the notes of New Plantation were largely subordinated to other indebtedness of the corporation—rarely a characteristic of purchase money obligations.

Beyond these purely factual elements, which would alone support, if they did not require, the conclusion that Mr. Jemison's guarantee was the primary obligation to which the sellers looked, the courts below employed familiar debt-equity criteria[2] in appraising

[1] The guarantee of Jemison Investment Company supplemented Mr. Jemison's guarantee by giving the sellers a direct claim against Mr. Jemison's principal asset.

[2] As the opinion of the court of appeals indicates (Pet. App. 13a–14a), the problem of debt-equity classification arises frequently, and in a number of contexts. The extensive catalog of factors that may appear relevant in one context or another has called for a case-by-case analysis and appraisal. In Section 415 of the Tax Reform Act of 1969, P.L. 91–172, 83 Stat. 613, adding Section 385 to the Internal Revenue Code of 1954, the Congress for the first time dealt with the problem by authorizing regulations specifically addressed to the question and by supplying a non-exclusive list of factors to be taken into account. The Senate Finance Committee, which proposed the

the status of the corporate obligation. They concurred in concluding that the corporate obligation was not such as would have been relied upon by a creditor to extend credit in an amount exceeding $600,000 to New Plantation. The concurring judgment of two courts upon the complex facts of a particular case does not call for review by this Court.

From the conclusion of the courts below that Mr. Jemison's guarantee was the primary obligation whereby he acquired beneficial ownership of the wrought iron furniture business operated by New Plantation, it follows that the decision that corporate payments on that obligation constituted dividends by the corporation, taxable to Mr. Jemison, was correct.

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amendment, described the problem in part as follows (S. Rep. No. 91-552, 91st Cong., 1st Sess., p. 137):

> *General reasons for change.*—It is a difficult task to draw an appropriate distinction between dividends and interest, or equity and debt. Even though a corporate obligation is labeled debt, it may be treated for tax purposes as equity, the payments on which accordingly are non-deductible dividends, if, in fact, the obligation represents an equity interest in the corporation. Some of the factors which may lead to the classification of a "debt obligation" of a corporation as equity include whether or not the bond or debenture is subordinated to the corporation's other creditors, whether or not the bond or debenture is convertible into stock of the corporation, and whether the corporation's debt-equity structure is such that it is reasonble to expect that it will be able to meet its obligations to pay the principal and interest on the bond or debenture when due.
>
> Although the problem of distinguishing debt from equity is a long-standing one in the tax laws, it has become even more significant in recent years because of the increased level of corporate merger activities and the increasing use of debt for corporate acquisition purposes.

That decision does not conflict with the decision of the Court of Appeals for the Ninth Circuit in *Murphy Logging Co.* v. *United States*, 378 F. 2d 222, where, on quite different facts, the court found the corporate purchaser of assets from a predecessor partnership financially able to sustain its obligations, and therefore relegated the stockholders' guarantee of a bank loan to secondary significance. That the two courts attributed somewhat different significance to the established earning power of Murphy Logging Company and the prospective earning power of New Plantation is not a conflict calling for review by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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